Supreme Court of the United States.

OCTOBER TERM, 1977.

No. 77-334.

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION OF BOSTON, ET AL.,
APPELLANTS,

v.

STATE TAX COMMISSION, ET AL.,
APPELLEES.

ON APPEAL FROM THE SUPREME JUDICIAL COURT OF MASSACHUSETTS.

Brief for the Appellants.

CHESTER M. HOWE,
MAXWELL D. SOLET,
OLIVER W. STALTER,
GASTON SNOW & ELY BARTLETT,
One Federal Street,
Boston, Massachusetts 02110.
(617) 426-4600
Attorneys for the Appellants.

ADDISON C. GETCHELL & SON, INC., THE LAWYERS' PRINTER, BOSTON

Table of Contents.

Table of Authorities Cited.

Cases.

Constitutional Provisions.

Statutes.

REGULATIONS.

MISCELLANEOUS.

Supreme Court of the United States.

OCTOBER TERM, 1977.

No. 77-334.

FIRST FEDERAL SAVINGS AND LOAN
ASSOCIATION OF BOSTON, ET AL.,
APPELLANTS,

v.

STATE TAX COMMISSION, ET AL.,
APPELLEES.

ON APPEAL FROM THE SUPREME JUDICIAL COURT
OF MASSACHUSETTS.

Brief for the Appellants.

Opinion Below.

The opinion of the Supreme Judicial Court of Massachusetts is reported at Mass. Adv. Sh. (1977) 895 and at 363 N.E. 2d 474 and is reproduced as Appendix A to the Jurisdictional Statement, which also includes, for convenience, the opinion in *United States* v. *State Tax Commission*, 481 F.2d 963 (1st Cir. 1973), as Appendix E.

Jurisdiction.

The judgment of the Supreme Judicial Court was entered May 3, 1977. On July 22, 1977, by order of Mr. Justice Brennan, the time within which to docket an appeal was extended to August 31, 1977. The appeal was docketed on August 31, 1977. This Court noted probable jurisdiction on November 14, 1977. The jurisdiction of this Court rests on 28 U.S.C. §1257(2).

Constitutional and Statutory Provisions Involved.

Article I, Section 8 of the United States Constitution provides:

> The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . .

Amendment XIV to the United States Constitution provides:

> No State shall . . . deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Section 5(h) of the Home Owners' Loan Act of 1933, 48 Stat. 132, as amended by 53 Stat. 1402 (1939), 65 Stat. 490 (1951), and 76 Stat. 984 (1962), 12 U.S.C. §1464(h) provides:

> No State, county, municipal, or local taxing authority shall impose any tax on such associations or their franchise, capital, reserves, surplus, loans, or income greater than that imposed by such authority on other similar local mutual or cooperative thrift and home financing institutions.

Chapter 63, Section 11 of the Massachusetts General Laws, as amended, provides:

> Every savings bank as defined in chapter one hundred and sixty-eight, every co-operative bank as defined in chapter one hundred and seventy and every state or federal savings and loan association located in the commonwealth shall pay to the commissioner an annual excise equal to the following:
>
> (a) on or before the twenty-fifth day of the seventh month of the taxable year, there shall be paid (1) six hundred twenty-seven one thousandths per cent of a reasonable estimate of its net operating income, as hereinafter defined, for the taxable year, and (2) one-sixteenth of one percent of the average amount of its deposits or of its savings accounts and share capital for the first six months of the taxable year, after deducting from such average amounts (i) its real estate used for banking purposes, valued at cost less reasonable depreciation, and (ii) the unpaid balances on its loans secured by the mortgage of real estate taxable in this commonwealth, or real estate situated in a state contiguous to the commonwealth, and within a radius of fifty miles of the main office of such bank or association, and in the case of a bank or association not previously subject to tax by this commonwealth the unpaid balances on such of its loans secured by the mortgage of real estate located outside of this commonwealth which are outstanding on March first, nineteen hundred and sixty-six, both as of the close of such sixth-month period; and
>
> (b) on or before the twenty-fifth day of the first month following the close of the taxable year, there shall be paid (1) one and two hundred fifty-four one

thousandths per cent of its net operating income, as hereinafter defined, for the taxable year, less the estimated amount previously paid with respect to such income, and (2) one-sixteenth of one per cent of the average amounts of its deposits or of its savings accounts and share capital for the second six months of the taxable year, after deducting from such average amount (i) its real estate used for banking purposes, valued at cost less reasonable depreciation, and (ii) the unpaid balances on its loans secured by the mortgage of real estate taxable in this commonwealth, or real estate situated in a state contiguous to the commonwealth, and within a radius of fifty miles of the main office of such bank or association, and in the case of a bank or association not previously subject to tax by this commonwealth the unpaid balances on such of its loans secured by the mortgage of real estate located outside of this commonwealth which are outstanding on March first, nineteen hundred and sixty-six, both as of the close of the taxable year.

For the purpose of this section, "net operating income" shall mean gross income from all sources, without exclusion, for the taxable year, less (i) operating expenses, (ii) net losses upon assets sold, exchanged or charged off as uncollectible during the taxable year, and (iii) minimum additions during the taxable years to its guaranty fund or surplus required by law or the appropriate federal and state supervisory authorities; and "taxable year" shall mean any fiscal or calendar year or period for which the bank is required to make a return to the federal government. Federal and state taxes paid or accrued during the taxable year shall not be deductible in computing "net operating income."

Questions Presented.

1. Does 12 U.S.C. §1464(h) prohibit the acknowledged discrimination in favor of Massachusetts-chartered institutions which results from the allowance of deductions for minimum required additions to guaranty fund or surplus?

2. Are Massachusetts credit unions, which are conceded to be "local mutual or cooperative thrift and home financing institutions," "similar" to Federal savings and loan associations under 12 U.S.C. §1464(h)?

3. Is the Massachusetts tax on Federal savings and loan associations restricted to the form of taxation and subjects of tax enumerated in 12 U.S.C. §1464(h)?

4. Does the Massachusetts statute violate the Commerce Clause of the United States Constitution by its failure to provide for apportionment of income to other states?

5. Does the failure to provide for apportionment of income derived from other states or the use of separate and unequal standards for measuring deductions violate the Due Process Clause of the Fourteenth Amendment to the United States Constitution?

6. Does the use of separate and unequal standards for measuring deductions violate the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution?

Statement of the Case.

The Appellants (hereinafter sometimes referred to as "the Associations") constitute all of the Federally-chartered savings and loan associations located within the Commonwealth of Massachusetts. Appendix (hereinafter

"A.") at 11. All were chartered pursuant to 12 U.S.C. §§1461-1468, all are members of the Federal Home Loan Bank System pursuant to 12 U.S.C. §§1421-1429, and all are insured by the Federal Savings and Loan Insurance Corporation pursuant to 12 U.S.C. §§1724-1730C. *Id.*

In the Home Owners' Loan Act of 1933, Congress authorized the states to impose certain taxes on Federal associations, provided that such taxes are no greater than those imposed on "similar" state-chartered institutions. 12 U.S.C. §1464(h).

In 1966, Massachusetts enacted Section 11 of Chapter 63 of the Massachusetts General Laws, imposing an excise tax on all Federal savings and loan associations located in the Commonwealth and on State-chartered savings banks and cooperative banks. The tax was imposed on "net operating income" (§§11(a)(1) and 11(b)(1)) and, nominally, on deposits (§§11(a)(2)and 11(b)(2)). In general, the deposits element of the tax allows a deduction for loans secured by real estate in Massachusetts but not for most non-Massachusetts real estate. The deposits element of the tax was struck down by the Court of Appeals as deliberately discriminatory to Federal associations. *United States* v. *State Tax Commission*, 481 F.2d 963 (1st Cir. 1973).

The critical facts concerning the income-based portion of the statute, which is the portion here challenged, are the following: (1) in arriving at "net operating income," a deduction from gross income is allowed for minimum additions to a guaranty fund or surplus required by statute or by State or Federal regulatory authorities, (2) while a deduction is provided for "operating expenses," the State Tax Commission and the Massachusetts Supreme Judicial Court have construed that term as not covering dividend or interest payments to depositors, (3) there is no provision

for apportionment or allocation to limit the tax to business activities in Massachusetts, and (4) the tax does not apply to Massachusetts credit unions.

A Massachusetts cooperative bank must set aside into a guaranty fund 10% of its assets at the rate of 5% of net profits per year. Mass. G.L. c. 170, §38. A Massachusetts savings bank must set aside 7½% of deposits at the rate of ⅛ to ¼ of 1% of total deposits for each six-month dividend period or a proportional amount thereof if a shorter dividend period is used. Mass. G.L. c. 168, §58(1). By contrast, Federal associations are required to set aside only 5% of insured accounts, which requirement must be met within twenty years or, if mortgage needs so require, within thirty years. 12 U.S.C. §1726(b). The rate of additions is determined by the Federal Savings and Loan Insurance Corporation, which is subject to the Federal Home Loan Bank Board. 12 U.S.C. §§1725(a) and 1726(b). The annual addition to reserves is currently required to be the amount necessary to bring such reserves to a level which increases by ¼ of 1% each year until reaching 5% of insured accounts and which remains constant thereafter. 12 C.F.R. §563.13(a)(1).

The Massachusetts Supreme Judicial Court found that the tax effect of the resulting differences in required additions to reserves was adversely discriminatory to the Federal associations. Mass. Adv. Sh. (1977) 895, 909, 363 N.E. 2d 474, 484.

All of the Associations are located within 100 miles of another state, and at least one is located in a city on the border of Connecticut, Maine, New Hampshire, New York and Rhode Island. See Appendix prepared for Supreme Judicial Court (hereinafter "SJC App.") at 3-12. The Associations derive substantial income from mortgage

loans with respect to real estate outside Massachusetts. A. 134.

Massachusetts-chartered credit unions have statutory power to make real estate loans on substantially the same terms and to substantially the same extent as Federal associations, as discussed *infra* at 37-38, and, in 1973, twenty Massachusetts credit unions had over fifty percent of their total assets invested in real estate loans. A. 146.

The Associations paid the taxes imposed by c. 63, §11, but for various assessment periods some or all of them protested the assessment of the tax and filed applications for abatement in accordance with Mass. G.L. c. 63, §§18A and 51. A. 12-13.

After denial of the applications for abatement, the United States challenged the deposits element of the tax on several statutory and State and Federal constitutional grounds by seeking declaratory relief in the Federal District Court for the District of Massachusetts. The District Court held the deposits element of the tax to be in violation of 12 U.S.C. §1464(h) and the Supremacy Clause. *United States* v. *State Tax Commission*, 348 F. Supp. 397, 400 (D. Mass. 1972). The Court of Appeals affirmed the holding on the exclusive ground that the tax was discriminatory in violation of 12 U.S.C. §1464(h). *United States* v. *State Tax Commission*, 481 F.2d 963, 970 (1st Cir. 1973).

Some of the Associations intervened in the Federal court litigation in order to challenge the net operating income portion of the tax, but the Court of Appeals exercised its discretionary power to withhold relief without consideration of the merits, since it found that an adequate remedy existed in the State courts. 481 F.2d at 971-976.

On April 16, 1975, the Associations commenced an action for declaratory relief in the Suffolk (County) Superior

Court. On December 24, 1975, the parties filed a Stipulation of Facts and motions for summary judgment. Prior to a decision on such motions, at the request of the parties, the case was reported without decision to the Appeals Court. On April 15, 1976, the Supreme Judicial Court for the Commonwealth of Massachusetts granted the Associations' motion for direct appellate review. On May 3, 1977, after briefs and oral argument, the Supreme Judicial Court issued a decision rejecting all of the Associations' State and Federal statutory and constitutional challenges to Mass. G.L. c. 63, §11. A. 3-5.

With respect to the argument that the Massachusetts statute discriminated against Federal associations, in violation of 12 U.S.C. §1464(h), because of differences in required additions to reserves, the Court stated:

> We think that the purpose of §1464(h) is not frustrated by the circumstance that reserve or guaranty fund requirements differ. The cause of the discrimination is the lower requirements imposed by the Federal regulatory agency on Federal savings and loan associations. The Commonwealth is not the source of the discrimination. The excise statute is wholly neutral.

Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482.

As to the argument that the tax was not one of those authorized in the Federal statute, the Court responded by characterizing the tax as a "franchise" tax and, in the alternative, as an "income" tax. Mass. Adv. Sh. (1977) at 904-905, 363 N.E. 2d at 480-481.

With respect to the argument that Massachusetts-chartered credit unions are "similar" institutions under 12 U.S.C. §1464(h), the Court stated:

> The test for similarity [of credit unions and Federal savings and loan associations] is not what each type

> of institution might do but rather what each does in fact . . . . The proper method of measuring similarity may be a collective, rather than an individual, comparison.

Id. at 913-914, 363 N.E. 2d at 484. Despite its finding that approximately 42% of all credit union loans were in real estate mortgages, the Court found a failure of proof that "... credit unions compete substantially . . . for the same types of investors and the same class of borrowers." *Id.* at 914, 363 N.E. 2d at 484. Hence it held that failure to tax credit unions did not lead to discrimination against Federal savings and loan associations in violation of 12 U.S.C. §1464(h).

With respect to the Commerce Clause issue, the Court stated:

> The record shows that collectively the associations invest a substantial portion of their funds (about 29% in 1974) in mortgage loans secured by real estate located in other States. The record does not show the extent of the contacts of any association with any other State nor does it show whether, in the circumstances of its business operations, any other State does or could impose a tax or excise on any association. Of course, no other State could impose an excise on an association's privilege to do business in Massachusetts . . . . Even if we assume, as the associations argue, that the issue of burdening interstate commerce turns on what other States may do, and not what they do in fact, the associations have not met their burden of establishing that §11 improperly imposes on interstate commerce. The tax is not invalid per se and, on this record, we cannot determine that it is forbidden by the commerce clause. The record is devoid of any information with respect to the contacts and activities of any individual Federal savings and loan association in any other jurisdiction.

Id. at 907-908, 363 N.E. 2d at 481 (citations omitted).

Finally, as to the Due Process and Equal Protection arguments, the Supreme Judicial Court stated:

> There is no fundamental unfairness in the due process sense. Every institution is placed in the same classification for tax purposes, but, even if we were to accept the assertion that the associations are placed in a separate class (because of the action of an agency of the Federal government), such a classification would not be impermissible. Legislative classifications for tax purposes are given wide respect in the face of constitutional challenges.

Id. at 910, 363 N.E. 2d at 482-483 (citations omitted).

Summary of Argument.

The deliberately complex Massachusetts statute taxing Federal savings and loan associations raises a comprehensive group of interpretive issues of first impression. Resolution of all issues presented would go far in shaping the permissible bases of taxation of Federal associations in all fifty states. Consequently, the opinion of this Court is likely to have a significant impact on both the operations of Federal associations and the cost of home financing.

Discrimination. The finding by the Massachusetts Supreme Judicial Court that discrimination adverse to Federal associations exists is not subject to serious challenge. The factual proof of discrimination is compelling. That finding of discrimination should, by itself, be sufficient to

cause the statute to fail. No erosion should be permitted of the view expressed by this Court in *Laurens Federal Savings & Loan Association* v. *South Carolina Tax Commission*, 365 U.S. 517 (1961), that 12 U.S.C. §1464(h) "unequivocally bars discriminatory state taxation of Federal Savings and Loan Associations."

The Massachusetts Court attempted to excuse this discrimination by stating that the source of the discrimination was Federal, since a Federal agency established the reserve requirement which governed the amount of the deduction in question. However, the source of discrimination is irrelevant under the statute. Further, it is the Massachusetts statute, not the Federal agency, which imposes the tax. Finally, the Federal agency could not eliminate the discrimination if it wished. Even if it could, to do so would be to forego regulatory powers intended to further national housing policies.

In addition, the Massachusetts Court implicitly held that a perceived competitive advantage in favor of Federal associations would justify offsetting tax discrimination against them. The Court then proceeded to burden Federal associations with the task of proving an overall competitive disadvantage in order to invalidate the tax.

The burden is inappropriate for several reasons. First, §1464(h) deals only with "similar" institutions. By definition, therefore, relative competitive standing has been substantially neutralized. This requirement of "similarity" contrasts with 12 U.S.C. §548, which requires parity of state tax treatment between national banks and any "moneyed capital . . . coming into competition" with them. Moneyed capital exists in many forms some of which are not employed in any phase of the business of banking. Even under §548 no balancing of competitive advantage by offsetting tax treatment is permitted. Tax parity is required if competition exists. Similarity assures competition.

Second, the very finding of adverse tax discrimination necessarily shows "an unequal and unfriendly competition" in which local institutions are favored. *Michigan National Bank* v. *Michigan*, 365 U.S. 467, 473 (1961). The finding of the Massachusetts Supreme Judicial Court is dispositive.

Third, even assuming that relative competitive standing might excuse a discriminatory tax, the state, rather than Federal savings and loan associations, must bear the burden of establishing the absence of hostile competition. The Massachusetts State Tax Commission has not attempted to establish the fact, and it cannot.

Finally, the Massachusetts Court's suggestion that lower reserve requirements give Federal associations a competitive advantage is itself erroneous. No facts exist to support it. Reserve requirements do not, in practice, have a substantial effect on capacity to pay dividends. Thus, there is no competitive advantage to neutralize discriminatory taxation.

"Similar" Credit Unions. "Similarity" of thrift institutions under the Federal statute ought properly to be judged on the basis of statutory purposes and powers. Competition is a necessary concomitant of similarity. The purposes of Massachusetts credit unions encompass and exceed the purposes of Federal associations. By statute, both are local thrift institutions which, in the case of credit unions, may make "loans . . . for provident purposes," Mass. G.L. c. 171, §2, while Federal associations accumulate primarily "to provide for the financing of homes." 12 U.S.C. §1464 (a). The latter purpose is clearly "provident" and included within the credit union purposes. As such Massachusetts credit unions have the larger scope and competitive impact.

The ability to make loans for other provident purposes provides a significant competitive edge to credit unions. A Massachusetts credit union can provide not only mortgage financing to purchase a home, it can provide credit for the car and furnishings needed to get to and enjoy the home. Credit unions can charge high consumer interest rates, 18% per year, and pay high interest to depositors, 8%. The advantages to either a depositing or borrowing "member" are considerably more attractive than those provided by Federal associations which are generally limited to a 5.25% dividend and individual home financing loans. The powers and purposes of the Massachusetts credit unions are similar to, and bring them into clear competition with, Federal associations.

Of the several other state courts which have considered the question of "similarity" between local credit unions and Federal associations, all have applied a standard of comparison that is identical to the standard under the Equal Protection Clause of the United States Constitution. As a result, minimal differences in powers or operations have been the basis for justifying discriminatory taxation. Moreover, and more important, the statutory standard of similarity established by §1464(h) has been merged into the equal protection standard by the state courts, and the statutory standard has become a redundancy, without independent effect. The approach is clearly erroneous.

Standards of "similarity" of thrift institutions under Federal law have not been established by this Court. However, in cases under the act authorizing taxation by states of national banks and cases under the Internal Revenue Code, substantial, if not exclusive, emphasis has been placed upon the powers available to the institution or entity, rather than the extent of their use, in judging the character of an entity.

In the national bank cases, the powers of the institution under consideration were largely the basis for judging its character. For example, in *Mercantile Bank* v. *New York*, 121 U.S. 138 (1887), "habitually exercised" powers were the basis for excluding trust companies from the definition of "banks," and savings banks were described as places for the "accumulation of small savings belonging to the industrious and thrifty." The 1935 decision by this Court in *Morrissey* v. *Commissioner*, 296 U.S. 344, remains the leading case for classification of business associations as corporations, partnerships or trusts under the Internal Revenue Code. There, the exclusive basis for judging the character of the entity was its powers since the full powers might be used at any time.

The powers and limitations of large Massachusetts credit unions and Federal associations are almost identical. Where differences exist the advantage is usually with the credit unions. The Massachusetts Court may have been prompted to conclude as it did out of concern for credit unions with small asset accumulations. Credit unions with less than $100,000 of assets are contemplated by the Massachusetts statute. Mass. G.L. c. 171, §24(A)6. It may be the small sized credit union that fosters the not uncommon notion of limited membership and limited resources for credit unions. However, large credit unions hold expanded powers comparable to Federal associations, and the statistical facts establish large credit unions as factual competitors with Federal associations. Twenty of the larger credit unions in the Commonwealth had over 50% of their assets in real estate loans. Total assets committed by the twenty credit unions to real estate loans in 1973 exceeded $170,000,000, a not insubstantial amount. It is not necessary to decide whether exemption on the basis of size would be justified

for the majority of credit unions. It is sufficent to recognize that twenty of the larger Massachusetts credit unions were in competition with the thirty-four Federal savings and loan associations to a substantial degree.

Massachusetts credit unions ought to be held to be "similar" institutions within the purview of §1464(h).

Limitations on Subjects and Form of Taxation. The states may tax Federal instrumentalities only to the extent authorized by Congress. Section 1464(h) limits the authority of the states to tax Federal associations to those subjects of taxation set out in the statute. Additionally, the section requires the imposition of a tax on identical subjects for both Federal and state institutions. For example, if a tax is imposed upon the capital of a Federal association, a no less burdensome tax must be placed upon the capital of its state counterparts.

Nor should §1464(h) be construed to permit to be done indirectly that which cannot be done directly. Massachusetts should not be permitted to "label" the tax as a franchise tax and measure the value of the Federal franchise largely by income, while measuring the value of State charters by a combination of income and deposits, which is the practical effect of the statute.

Valid comparisons simply cannot be made unless the objects to be compared are alike. The necessity for direct comparison flows from both the Federal statutory language and a decision of this Court. The approximate parity of taxation permitted in the taxation of national banks and other moneyed capital does not satisfy the "unequivocal" prohibition of discriminatory state taxation of Federal savings and loan associations set out by this Court in the *Laurens* case.

The Massachusetts Supreme Judicial Court failed to address directly the issues of the limitations of form and

subjects of taxation imposed by §1464(h) except in result. The Court characterized the §11 tax as a franchise tax measured by "deposits" and "income." The characterization is erroneous for three reasons.

First, other than nominally, deposits are no measure of the tax since a deduction from deposits is allowed for the value of real estate mortgage loans and banking facilities, which generally exceeded 70% of deposits for savings banks and 83% of deposits for cooperative banks. A. 135-144. While total deposits are an appropriate measure of the value of a franchise, that small portion of deposits allocated to out-of-state mortgage loans, intangible investments and personal loans (the real objects of tax here) does not appear to be an accurate measure of the value of the franchise.

Second, the so-called "net operating income" measure of the tax permits no deduction for the largest single cost of operation — payments to depositors — and injects a deduction unrelated to income—mandated additions to guaranty funds or surplus. Both are contrary to the treatment for Federal income tax purposes and other definitions of income. While an income measure is also an approved standard for valuing a franchise, income in name alone is not an acceptable standard.

Third, Federal associations are intended to function nationally, and a substantial portion (approximately 35%) of their income is extraterritorial to Massachusetts. A. 134. Yet §11 contains no provision for apportionment of income outside Massachusetts, despite the requirement that a franchise tax fairly reflect only the annual benefit provided by the taxing state for the exercise of corporate privileges under Massachusetts law. *State Tax Commission* v. *John H. Breck, Inc.*, 336 Mass. 277 (1957). Again, while the value

of a franchise may be measured by income, such income must be apportioned to include only that which results from exercise of the franchise in the taxing state.

Finally, the income-based portion of the tax fails to satisfy the other enumerated bases of taxation as well. Despite the alternative holding of the Massachusetts Court, the fact that, as indicated above, the definition of "net operating income" permits no deduction for the largest single cost of operation and injects a deduction unrelated to income precludes characterization as a tax on "income," as that term is understood for Federal income tax, accounting, and economic purposes or in everyday usage.

The Massachusetts statute defies proper characterization, in part, because of the divergence between nominal and real objects of taxation. However described, it is, in design and operation, outside the scope of permitted state taxation of Federal savings and loan associations as to both form and substance.

Commerce Clause. The tax in question makes no provision for apportionment of income among the states. The Associations derive significant amounts of income from mortgage loans secured by non-Massachusetts real estate. These loans commit them on a long-term basis to maintaining contacts with other states sufficient to support the imposition of taxes by such states. Since the unapportioned Massachusetts tax reaches every dollar of the Associations' income, including income from out-of-state loans, any tax by another state would constitute multiple taxation. Congress has been and is concerned with the threat of multiple state taxation of financial institutions including Federal savings and loan associations. Hearings are now in progress on the subject, and Congress temporarily prohibited such taxation by the State Taxation of Depositories Act.

The real and substantial risk of multiple taxation by itself impedes the free flow of funds among the states and thus burdens interstate commerce in violation of the Commerce Clause. *Gwin, White & Prince, Inc.* v. *Henneford*, 305 U.S. 434 (1939).

Due Process Clause. The failure of the Massachusetts tax statute to provide some means of apportionment of income among the states also violates the Due Process Clause, which prohibits the states from taxing income not attributable to transactions within its jurisdiction. *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931). Where a transaction involves more than one state, apportionment is required. *Underwood Typewriter Company* v. *Chamberlain*, 254 U.S. 113 (1920).

In addition, the statute's use of different methods for computing the deduction for required reserve additions results in an unreasonable and arbitrary discrimination against Federal associations in violation of the Due Process Clause. The reserve requirements imposed on Federal associations by Federal statute and regulation have consistently resulted in lower deductions for them than for the admittedly similar Massachusetts-chartered thrift institutions, which are subject to higher reserve requirements imposed by Massachusetts statutes.

Equal Protection Clause. The use of different methods of computing the deduction for reserve additions also violates the Equal Protection Clause. Though Federal associations and State-chartered cooperative and savings banks have been held to be similar, the deduction is measured for the former by Federal reserve requirements and for the latter by higher Massachusetts requirements. This results in a greater tax burden on Federal associations, denying them the equal protection of the laws.

Argument.

A. The Acknowledged Discrimination Against Federal Savings and Loan Associations may Not Be Excused or Justified.

The Massachusetts Supreme Judicial Court found that Federal associations are objects of discriminatory taxation as a result of the deductibility from taxable income of mandatory additions to an institution's guaranty fund or surplus. The issue presented is whether such discrimination has been excused or justified in order not to offend the requirement of 12 U.S.C. §1464(h) that no greater tax be imposed on Federal savings and loan associations than is imposed on similar local institutions.

Mechanically, the Massachusetts statute authorizes a deduction from "net operating income" for "minimum additions . . . to its guaranty fund or surplus required by law or the appropriate federal and state supervisory authorities." Mass. G.L. c. 63, §11. As a result, a Massachusetts cooperative bank is allowed an annual deduction equal to 5% of net profits until a guaranty fund equal to 10% of assets is accumulated. Mass. G.L. c. 170, §38. A Massachusetts savings bank is allowed an annual deduction equal to ¼ of 1% of total deposits until a guaranty fund equal to 7½% of deposits is accumulated. Mass. G.L. c. 168, §58(1).

Federal savings and loan associations currently are required to reserve only 5% of checking and savings account balances, to be accumulated at the rate necessary to increase reserves by ¼ of 1% of such balances each year for 20 years. 12 C.F.R. §563.13(a)(1). The Federal Savings and Loan Insurance Corporation may vary this schedule by regulation so long as the 5% level is reached within twenty years or, in the case of an individual insti-

tution, may extend the period by as much as ten additional years in the case of an individual institution if such action is determined to be necessary to meet mortgage needs. 12 U.S.C. §1726(b).

The above differences in the rates of additions to reserves and in ultimate reserve requirements have resulted in larger deductions and lower taxes for Massachusetts-chartered institutions in comparison to Federal savings and loan associations. The Supreme Judicial Court acknowledged the existence of this adverse discriminatory treatment of Federal associations in the following terms:

> . . . we accept the [Federal] associations' assertion that, generally, the required contributions of a Federal savings and loan association to its surplus are less than those of similarly situated Massachusetts savings and cooperative banks.

Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482. However, the Court held that such discrimination did not violate 12 U.S.C. §1464(h) for two reasons.

First, according to the Court, the discrimination was excused because

> The cause of the discrimination is the lower requirements imposed by the Federal regulatory agency on Federal savings and loan associations. The Commonwealth is not the source of the discrimination. The excise statute is wholly neutral.

Id. The source of discrimination cannot be relevant in view of the absolute prohibition by §1464(h) of discriminatory taxation of Federal associations. In any event, the Commonwealth is the source of the discrimination here since the tax is imposed under Massachusetts law, not Federal law.

Second, according to the Massachusetts Court,

> The operation of §11 in conjunction with the less strict reserve requirements applicable to Federal savings and loan associations has not been shown to present a substantial competitive disadvantage. Because of lower reserve requirements, Federal associations tend to have more funds available for immediate distribution to members than similarly situated State institutions.

Id. The Associations submit that (a) there is no support for the imposition of the "substantial competitive disadvantage" standard applied by the Court, (b) if discrimination may be justified, the burden of justification falls upon the State, and (c) the supposed increased dividend capacity of Federal associations relied upon as an offsetting advantage for such associations is pure speculation without factual support in the record and contrary to fact.

The source of adverse discriminatory tax treatment is an irrelevant inquiry. The plain wording of 12 U.S.C. §1464(h) is that no tax may be imposed on Federal associations "greater than" is imposed on local institutions. This Court, in its only interpretation of that provision, has stated that §1464(h) ". . . unequivocally bars discriminatory state taxation of the Federal Savings and Loan Associations." *Laurens Federal Savings and Loan Association* v. *South Carolina Tax Commission,* 365 U.S. 517, 523 (1961). It having been established that the tax on Federal associations is greater, the Massachusetts statute must fall.

Further, the Court's conclusion that the Federal government is the source of the discrimination is simply wrong. The Federal statute imposes no tax; only the Massachusetts statute does that. While it may be true

that "Congress must have recognized that reserve requirements would differ between Federal savings and loan associations and State savings institutions." Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482, Congress certainly cannot be deemed to have authorized the states to make such a difference the basis for imposition of unequal tax burdens in the face of the clear Federal prohibition of discrimination.

Moreover, a review of the history of the deduction for additions to reserves supports the view that deliberately discriminatory treatment of Federal associations was intended, parallel to that involved in the tax on out-of-state loans, nominally imposed on deposits, §§11(a)(2)(ii) and (b)(2)(ii) of Mass. G.L. c. 63, which was condemned by the Court of Appeals in *United States* v. *State Tax Commission,* 481 F.2d 963 (1st Cir. 1973). The amount of reserves, and rates of additions to reserves, required for Massachusetts cooperative and savings banks were fixed by statute prior to the 1966 enactment of §11, as was the amount of the reserve requirement for Federal associations. There is no reason to believe that the legislature acted out of ignorance rather than with knowledge of the effect of its own enactments. The legislature must have known the rates of addition and ultimate amounts of the reserves required. It is more probable that the legislature deliberately attempted to provide tax reductions for local institutions either as a distinct benefit or as an offset to perceived competitive disadvantages which local institutions might incur. As the Court of Appeals said:

> Federal associations are entitled not to be singled out for special tax burdens; and it makes no difference whether the latter are expressly written into the statute or are tailored, as here, more subtly.

481 F.2d at 970.

Even if the Federal agency responsible for establishing the rate of reserve additions by Federal associations were to act so as to minimize Massachusetts taxes, it could not eliminate the discriminatory result. The Massachusetts Court has suggested that the Federal Savings and Loan Insurance Corporation could, by accelerating the rate of required contributions to reserves by Federal associations, reduce, eliminate or reverse the discriminatory tax result, and that its failure to do so made it the source of the discrimination. It is true that if the ultimate reserve requirement for Federal associations of 5% of insured accounts were required to be met in one year's time rather than over 20 years, Federal associations probably would have larger deductions, in that one year, than would State institutions. The argument fails, however, since the larger ultimate reserve requirements of State institutions necessarily provide larger total deductions eventually. In the case of a Massachusetts cooperative bank, for example, which ultimately must reserve 10% of deposits, the deductions in time will total more than twice those of a comparable Federal association, required to reserve only 5% of checking and savings account balances.

More importantly, the power conferred upon the Federal Savings and Loan Insurance Corporation to regulate the rate of additions to reserves of Federal associations was obviously designed to advance the national goals of promotion of thrift, safety of deposits, and the regulation of the supply and flow of funds for home financing. The power clearly was not conferred to neutralize discriminatory state taxing policies; that result was mandated by §1464(h). It should be noted that this power to alter by regulation the rate of additions to reserves has been exercised on a number of occasions, *e.g.* 16 Fed. Reg. 1818 (1951), 21 Fed. Reg. 5483 (1956), 29 Fed. Reg. 7090 (1964), while

Congress, in the Emergency Home Finance Act of 1970, extended to 30 years the period in which to satisfy the reserve requirement, if "necessary to meet mortgage needs." 84 Stat. 463 (1970). Congress could hardly have intended that the effective use of important regulatory tools which it had provided be sacrificed in order to eliminate discriminatory results of state taxation when such results could be, and had been, forbidden directly.

The Massachusetts Court's inquiry as to whether a "substantial competitive disadvantage" existed also is not warranted. Again, the plain words of the Federal statute prohibit any state tax "greater than" that imposed on state-chartered institutions. Had Congress wished to forbid only those taxes imposing a "substantial competitive disadvantage," it would have so provided. This Court's statement in the *Laurens* case that 12 U.S.C. §1464(h) "unequivocally" bars discriminatory taxation provides for no exceptions, 365 U.S. at 523, and should not be eroded.

As a minimum, the Commonwealth should have the burden of showing "just reason" for discrimination once discrimination has been shown, as required under 12 U.S.C. §548, which prohibits discriminatory taxation of national banks. *Michigan National Bank* v. *Michigan,* 365 U.S. 467, 473 (1961). Compare dissent, *id.* at 497-498, as to whether any discrimination may be excused in the case of national banks. The State Tax Commission has made no attempt to provide a reasonable basis for the local preference. Unlike 12 U.S.C. §548, which prohibits discrimination in favor of "other moneyed capital . . . coming into competition with the business of national banks," 12 U.S.C. §1464(h) is concerned only with whether or not favored institutions are "similar." This difference in approach may be attributed to the fact that na-

tional banks are in competition with a wide variety of moneyed capital. Because of that variety, significant competitive differences may exist which might justify preferential treatment of local institutions in certain instances. Thrift institutions have a narrower focus of operation, however, and 12 U.S.C. §1464(h) therefore deals only with whether institutions are "similar." That very similarity, once determined to exist, should make inquiry into perceived competitive differences unnecessary. Proof—or disproof—of such fine differences would be a difficult burden.

Further, the basis for the Supreme Judicial Court's conclusion that a substantial competitive advantage had been shown, offsetting the burden of discriminatory taxation, is without factual foundation and was not advanced by the Commonwealth. The Court stated:

> Because of lower reserve requirements, Federal associations tend to have more funds available for immediate distribution to members than similarly situated State institutions.

Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482. The record is devoid of evidence concerning the relative dividend paying capacities of the various types of institutions. In any event, permissible dividends are primarily a function of action by the appropriate regulatory authorities. The Massachusetts Commissioner of Banks establishes limitations on the rate of interest or dividends payable on deposits by non-Federally insured Massachusetts banks, including savings banks and cooperative banks. Mass. G.L. c. 167, §18B(2). Those State-chartered thrift institutions which are insured by the Federal Deposit Insurance Corporation are subject to interest or dividend limitations established by its Board of Directors. 12 U.S.C. §1828.

Federal savings and loan associations are subject to limitations established by the Federal Home Loan Bank Board. 12 U.S.C. §1425b(a).

As an illustration of how dividend levels are actually determined, when Massachusetts banks not subject to Federal limitations were authorized to pay 5¼% on regular savings accounts in contrast to the 5% limitation applicable to Federal associations, Regulation of the Commissioner of Banks, July 31, 1970, the Federal Home Loan Bank Board made an exception to its national rule, allowing institutions whose home office was in Massachusetts to pay 5¼%. 35 Fed. Reg. 12388 (1970). In addition, when, in 1972, State institutions were allowed to pay interest on so-called Negotiable Order of Withdrawal ("N.O.W.") accounts, *Consumer Savings Bank* v. *Commissioner of Banks*, 361 Mass. 717 (1972); Mass. G.L. c. 167, §16A, Congress followed the State and authorized those Federal associations located in Massachusetts to do the same. P.L. 93-100, §2, 87 Stat. 342 (1973), 12 U.S.C. §1832. This series of competitive State and Federal regulatory actions strongly supports the view that Massachusetts thrift institutions, not Federal associations, had a superior dividend paying capacity. Thus, while reserve requirements constitute a threshold condition to any dividend payment, they have little effect, in practice, on the amount of dividends actually paid. Neither fact nor argument can support the view that lower reserve requirements give Federal savings and loan associations a competitive advantage to help offset their burden of greater taxation.

Finally, it should be noted again that the Supreme Judicial Court of Massachusetts conceded that the tax in question discriminates against Federal savings and loan associations. Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482. The issue here is only whether such discrimina-

tion may be excused. In the brief filed in support of their motion to dismiss the appeal in this case, the Appellees argued only that no discrimination exists. That argument is not only too late but also baseless.

Perhaps the most dramatic example of the fact of discrimination is provided by the tables in the Appendix. Of the 147 cooperative banks *all* received deuctions for guaranty fund additions for *all* years except for two banks. The Grafton and New Bedford Acushnet cooperative banks qualified for deductions in some but not all years. A. 16-61. Most Federal associations, on the other hand, repeatedly failed to qualify for deductions. Twenty-five of the thirty-four Federal associations in the Commonwealth obtained no deduction on at least two occasions over the seven years for which statistics were available. A. 112-129. In particular, Bay State Federal Savings and Loan Association was entitled to *no deduction for any year*. A. 113.

In their brief, the Appellees noted that Federal associations received a greater deduction for reserve additions than did Massachusetts cooperative banks in the most recent year shown in the record. Appellees' Brief in Support of Motion to Dismiss at 14. Omitted was the fact that cooperative banks received larger aggregate deductions for additions to reserves than did Federal associations in six out of the seven years for which complete data is shown in the record. A. 131-132. State savings banks received larger aggregate deductions than Federal associations in four of the seven years, equal deductions in one year, and lesser deductions in two years. *Id.* The record is more than ample to support the Supreme Judicial Court's finding of adverse discrimination against Federal associations, and that finding should be sustained.

The Appellees' brief to this Court also raised for the first time in this litigation the argument that the discrimination contained in the income-based portion of the tax was purged of taint by the earlier holding of the U. S. Court of Appeals that the deposits portion of the tax was discriminatory and therefore invalid as to Federal associations. This argument should be rejected for several reasons. First, as the Commonwealth acknowledged, the record contains no support for the argument. Appellees' Brief in Support at 11.

Second, the argument was not raised in the courts below, and the Appellees therefore should be precluded from raising it here. *See Hormel* v. *Helvering,* 312 U.S. 552, 556-557 (1941); *Singleton* v. *Wulff,* 428 U.S. 106, 119-121 (1976).

Third, the opinion of the Massachusetts Court indicates that it was fully aware of the inapplicability of the deposits portion of the tax to Federal associations. Mass. Adv. Sh. (1977) at 898, 363 N.E. 2d at 478. Nevertheless, it proceeded to analyze the Associations' discrimination arguments by reference solely to the income-based portion of the tax.

Fourth, the effective functioning of the judicial process in a federal system requires that litigants not be denied relief because of the choice of a Federal or state forum in which to bring actions combining both Federal and state issues or because the chosen court sees fit to abstain as to particular issues in the interest of comity. The Federal courts, in which the tax imposed by §11 was first challenged, had jurisdiction to decide both the Federal and state law issues presented as to both the deposits and the income-based portions of the tax. The District Court decided the Federal issues as to both portions but abstained as to the state law claims on the ground

that they were then pending before the State Tax Commission. *United States* v. *State Tax Commission,* 348 F. Supp. 397, 401 (D. Mass. 1972). The Court of Appeals upheld this abstention and abstained further from ruling on the Federal challenge to the income-based portion of the tax on the ground that the taxpayers had a "plain, adequate and complete" remedy in the Massachusetts courts. *United States* v. *State Tax Commission,* 481 F.2d 963, 973 (1st Cir. 1973). While discretionary abstention by the Federal Court inevitably resulted in a hiatus between its grant of partial relief and a final determination by the state courts, the Court of Appeals could not have intended that its action would preclude any further relief.

Fifth, and last, there is no logic to preferring one discriminatory tax provision over the other. The discrimination inherent in the income-based portion of the tax certainly is made no less offensive by a holding that the deposits-based portion, enacted together with it, is deliberately discriminatory. The order in which the two portions are addressed by the courts cannot alter the validity of either.

B. Massachusetts Credit Unions Are Mutual Thrift and Home Financing Institutions "Similar" to Federal Savings and Loan Associations.

Massachusetts credit unions are conceded to be "local mutual or cooperative thrift and home financing institution[s]." Mass. Adv. Sh. (1977) at 912, 363 N.E. 2d at 483. The issues here are what standards should be used in judging whether Massachusetts credit unions are "similar" to Federal savings and loan associations within the meaning of 12 U.S.C. §1464(h) and whether that standard has been met.

1. *Standards of Similarity.*

The Associations urge that the proper focus of comparison is the statutory powers conferred upon the two kinds of entities. The Massachusetts Court rejected this standard, stating: "The test for similarity is not what each type of institution might do but rather what each does in fact . . . ." Mass. Adv. Sh. (1977) at 913, 363 N.E. 2d at 484. In so holding, the Court failed to distinguish the many opinions of this Court under 12 U.S.C. §548 which deal with the question of whether moneyed capital is in substantial competition with national banks and the opinion of this Court in *Morrissey* v. *Commissioner,* 296 U.S. 344 (1935), which is the leading case on classification of entities as associations taxable as corporations, trusts, or partnerships under the Internal Revenue Code.

In *Mercantile Bank* v. *New York,* 121 U.S. 138 (1887), Justice Matthews focused on the *powers* of New York trust companies to determine whether they were "banking institutions" similar to national banks, stating:

> Trust companies . . . in New York, according to the powers conferred upon them by their charters and habitually exercised, are not in any proper sense of the word banking institutions. They have the following powers: To receive moneys in trust and to accumulate the same at an agreed rate of interest; to accept and execute all trusts of every description committed to them by any person or corporation or by any court of record; to receive the title to real or personal estate on trusts created in accordance with the laws of the state and to execute such trusts; to act as agent for corporations in reference to issuing, registering, and transferring certificates of stock and

bonds, and other evidences of debt; to accept and execute trusts for married women in respect to their separate property; and to act as guardian for the estates of infants. It is required that their capital shall be invested in bonds and mortgages on unincumbered real estate in the State of New York worth double the amount loaned thereon, or in stocks of the United States or of the State of New York, or of the incorporated cities of that state.

> *It is evident, from this enumeration of powers, that trust companies are not banks in the commercial sense of that word,* and do not perform the functions of banks in carrying on the exchanges of commerce.

Id. at 159 (emphasis added).

That the proper focus of inquiry should be the statutory powers of the entities is supported by a comparison of the language of 12 U.S.C. §1464(h) with that of 12 U.S.C. §548, the provision granting to the states power to tax national banks. In *Michigan National Bank* v. *Michigan,* 365 U.S. 467 (1961), this Court stated that those two statutory provisions are to be read "in pari materia." *Id.* at 481. The two statutes are thus to be construed by reference to one another. The language of 12 U.S.C. §548 explicitly limits the proscriptions of that statute to the unequal taxation of moneyed capital "coming into competition with the business of national banks" and so requires consideration of the actual uses to which the various kinds of moneyed capital might be put. By contrast, the language of 12 U.S.C. §1464(h) makes no reference to actual competition and gives no indication that the proscriptions of the statute are to hinge on it. Construing the two statutes by reference to each other, it appears that "similarity," under 12 U.S.C. §1464(h), is

to be judged solely by "what each type of institution might do," in contrast to the inquiry as to actual competition required under 12 U.S.C. §548.

In the *Morrissey* case, a trust with transferable shares had been created to develop a tract of land through the improvement and sale of a portion of the tract and to construct a golf course on the balance of the land. All sales activity had been completed prior to the beginning of the tax years before the Court. The trustees argued that the absence of business activities in those years should be taken as evidence of the character of the trust. Rejecting the test of "what each does in fact," imposed here by the Massachusetts Court, and adopting instead the test of "what each type of institution might do," this Court stated:

> The fact that these sales were made before the beginning of the tax year here in question . . . did not alter the character of the organization. *Its character was determined by the terms of the trust instrument* . . . . The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized.

296 U.S. at 361 (emphasis added).

In those instances in which the Massachusetts Court has addressed the issue of "similarity," it has failed to consider the cases discussed above and has failed to clearly articulate the basis for its holdings. In two cases, that Court held local cooperative and savings banks to be similar to Federal associations because of their common "appeal to the same type of investor and to the same class of borrowers." *Commissioner of Corporations and Taxation* v. *Flaherty,* 306 Mass. 461 (1940), *cert. denied,* 312

U.S. 680 (1941); *Springfield Institution for Savings* v. *Worcester Federal Savings and Loan Association,* 329 Mass. 184, *cert. denied,* 344 U.S. 884 (1952). Neither case discloses the basis upon which the judgment was reached. Nor is there any indication whether the judgments were based upon a comparison of statutory purposes and powers, factual operations or some combination of both.

Of the state court opinions which have considered the credit union issue, each has also failed to address the national bank cases or the *Morrissey* case. See discussion of those opinions *infra* at 42-45. To the extent that a standard can be discerned, those courts appear to have applied an Equal Protection Clause standard, thus making the affirmative command of the Federal statute superfluous.

As a frame of reference for deciding whether the similarities of Massachusetts credit unions to Federal associations are substantial, it is instructive to consider the relationship of both entities to national banks. In *Michigan National Bank* v. *Michigan,* 365 U.S. 467, 470 (1961), this Court assumed, for purposes of the decision under 12 U.S.C. §548, that state savings and loan associations were moneyed capital in substantial competition with national banks. It also suggested, without deciding, that 12 U.S.C. §1464(h) might allow states to exempt state thrift institutions from the tax imposed on national banks, so long as they were taxed to the same extent as Federal associations. *Id.* at 481. While the issue is not present here, it would appear highly probable that Massachusetts credit unions also represent moneyed capital in substantial competition with national banks. The managing director of the Credit Union National Association has been quoted as stating:

> The [commercial] banks have lately decided . . . that the future is in consumer lending . . . . They are walking all over our [the credit unions'] side of the street . . . . In addition, the credit unions would like to move more aggresively into the territory of savings and loan associations—home mortgages.

Boston Sunday Globe, June 6, 1976, at 8, col. 4.

Given the increasing competition between credit unions and national banks, it is fair to predict that one or more national banks will challenge their liability under state tax statutes which give a privileged status to credit unions. The probability of such a challenge almost certainly will be enhanced if Massachusetts credit unions are found to be "not similar" to Federal associations since, collectively, they ought to be in one category or the other. If, however, credit unions are held to be "similar" institutions within the meaning of 12 U.S.C. §1464(h), the states might permissibly tax all thrift institutions, both Federal and state, preferentially.

2. *Statutory Powers.*

If similarity is to be determined by reference to their respective powers, as the Associations urge, Massachusetts credit unions must be held to be similar to Federal associations. It should be noted at the outset that Massachusetts credit unions are, in their powers and their practices, quite different from Federal credit unions and from those chartered by many other states, which have restricted membership and cannot enter into residential home financing in a practical sense. *See, e.g.,* 12 U.S.C. §§1757(5), 1759.

The statutory powers of Massachusetts credit unions are scaled, to some extent, according to the size of the individual credit union. Mass. G.L. c. 171, §§24(A) and 24(B). The Massachusetts tax statute, however, fails to make similar distinctions. All Massachusetts credit unions, from

the smallest to the largest, regardless of their powers and practices, are granted a blanket exemption from State taxation.

As indicated below, the statutory powers of Federal associations and Massachusetts credit unions are similar with respect to the three primary phases of their operation: (1) the mutuality of ownership and control, (2) the ability to attract savings, and (3) the ability to make first mortgage residential real estate loans. To the extent that the powers are not identical, it is the credit unions which have greater powers and an improved competitive position as contrasted to Federal associations.

Mutuality of ownership and control is required for Federal associations and Massachusetts credit unions by similar statutory provisions. Unlike national banks, these entities do not have a class of stockholders separate and distinct from their depositors and borrowers. *See Michigan National Bank* v. *Michigan,* 365 U.S. 467, 482 (1961). All depositors and borrowers of these entities are called "members," and the members all have the right to vote in the election of directors. 12 C.F.R. §554.1; Mass. G.L. c. 171, §13. Every member of a Federal association is entitled to at least one vote and no more than fifty votes. 12 C.F.R. §544.1(a) and (b). Every member of a Massachusetts credit union is entitled to one, but only one, vote. Mass. G.L. c. 171, §§10, 13 and 24. Thus, both entities limit voting rights so that no single member may cast more than a small percentage of the total votes.

As to the ability to attract savings, larger Massachusetts credit unions have the power to accept deposits or issue shares on terms similar to those offered by Federal associations. In a credit union with over $4,000,000 in specified assets, individual deposit or share accounts of $33,000 are permitted while joint accounts may total

$66,000. Mass. G.L. c. 171, §10, as amended by Acts 1977, c. 15. Credit union deposits may be insured by the National Credit Union Association. Mass. G.L. c. 171, §35, 12 U.S.C. §1781(a). The accounts of depositors in Federal associations are insured by the Federal Savings and Loan Insurance Corporation. 12 U.S.C. §1728(a). In addition, Massachusetts credit unions are limited, with minor exceptions, to dealing with the individual, non-commercial depositor and borrower, whose business they share with Federal associations. 5 Opinions of the Attorney General of the Commonwealth of Massachusetts 269 (1918); Mass. G.L. c. 171, §5. Recent statutory enactments permit Massachusetts credit unions, along with savings banks and savings and loan associations, to accept deposits of legacies, unclaimed monies and fiduciary deposits. Acts 1977, c. 16-18. Further, credit unions are authorized to pay an interest rate approximately 50% greater than Federal associations may pay. Credit unions may pay a maximum interest rate of 8%, Mass. G.L. c. 171, §25, whereas Federal associations are limited to an interest rate of 5 1/4% on ordinary deposits. 12 C.F.R. §526.3. In this respect, credit unions have a clear competitive advantage over Federal associations in attracting deposits. In summary, the power of Massachusetts credit unions to attract savings is at least as strong as that of Federal associations.

Finally, and most important, Massachusetts credit unions have the statutory power to make residential real estate loans on substantially the same terms and to substantially the same extent as Federal associations. Credit unions have the statutory authority to make loans secured by first liens on real estate for terms up to 30 years, for 90% of the value of the property and to a maximum

amount of \$50,000. Mass. G.L. c. 171, §§24(B)(a)(4) and (b)(8), as amended by Acts 1977, c. 22. Federal associations may make real estate loans for a maximum term of 30 years, to the extent of 80% of the value of the property, and to a maximum amount of \$55,000. 12 U.S.C. §1464(c); 12 C.F.R. §545.6-1(a)(i). Real estate loans may be made anywhere within Massachusetts by a credit union, Mass. G.L. c. 171, §24(B)(b)(4), or a Federal association, 12 C.F.R. §545.6-6, with its principal place of business within the Commonwealth. Finally, large credit unions may invest up to 80% of their assets in real estate loans, Mass. G.L. c. 171, §24(B)(b)(7), while Federal associations may invest 95% of their assets in real estate loans. 12 U.S.C. §1425a(b); 12 C.F.R. §523.11.

In only two instances do the statutory provisions governing Massachusetts credit unions appear to be noticeably different from the provisions governing Federal associations. In both instances the differences are largely illusory First, Massachusetts credit unions may make loans only to members. Mass. G.L. c. 171, §24. There are, however, no statutory provisions that limit the membership of a credit union, and the smallest deposit in a credit union will qualify a prospective borrower as a member. Second, Massachusetts credit unions are admonished to give "preference" to personal loans. Mass. G.L. c. 171, §24. The statute does not, however, provide any method for enforcement of the preference provision other than by way of limitations related to the size of the union.

The Massachusetts Court also found the statutory purposes of Massachusetts credit unions and Federal associations to be different. Mass. Adv. Sh. (1977) at 913, 363 N.E. 2d at 484, n.9. However, the statutory purposes of the former institutions encompass that of the latter. The purposes of Massachusetts credit unions are to accumulate and invest savings of members and to make loans for provident purposes, Mass. G.L. c. 171, §2, while the purpose of Federal associations is to provide local mutual thrift institutions in which people may invest their funds in order to provide for the financing of homes. 12 U.S.C. §1464(a). Obviously, home financing is a "provident" purpose. Consequently the purposes of credit unions encompass and extend beyond the purpose of Federal associations and should be held to be similar.

3. *Actual Practices.*

Even if similarity were to be determined by reference to the actual practices of Massachusetts credit unions and Federal associations, this Court should nevertheless hold that the two types of entities are similar. Because determination of similarity under 12 U.S.C. §1464(h) is a question of Federal law, this Court is not bound by the conclusion of the court below. As this Court has stated, in scrutinizing actual competition against national banks under 12 U.S.C. §548, "The question is . . . a mixed one of law and fact, and in dealing with it we may review the facts in order correctly to apply the law." *First National Bank of Hartford, Wisconsin* v. *City of Hartford*, 273 U.S. 548, 552 (1927). In the present case, the facts submitted by the Federal associations consist primarily of statistics compiled and published by the Commonwealth itself and are thus particularly appropriate for independent analysis by this Court. These statistics establish that larger Massachusetts credit unions are in actual and substantial competition with Federal associations.

In actual practice, larger Massachusetts credit unions compete with Federal associations in the area which produces the great majority of such associations' revenue, viz.

home mortgage loans. As acknowledged by the Massachusetts Court, Massachusetts credit unions in 1972 placed 30.1% of their total investments and 42% of their total loans in real estate mortgages. Mass. Adv. Sh. (1977) at 914, 363 N.E. 2d at 484. Thus, Massachusetts credit unions collectively invested in real estate loans to nearly the same extent they invested in personal loans. The percentages for 1972 are representative of all years relevant to this action beginning with 1966. See A. 136-144. In terms of dollars, Massachusetts credit unions had total assets in excess of one *billion* dollars and real estate loans of $329,499,463. Annual Report of the Massachusetts Commissioner of Banks for 1973, Section B at 84.

Many individual Massachusetts credit unions have made real estate loans in excess of personal loans. In 1973, twenty of the larger credit unions invested more than 50% of their total assets in home mortgage loans, five credit unions invested more than 70% of their assets in home mortgage loans, and one credit union invested over 86% of its assets in home mortgage loans. In terms of dollars, the real estate loans by these 20 credit unions totalled over $170,000,000. A. 146. Over 50% of Massachusetts credit unions made some real estate loans and those credit unions held over 80% of the total assets of Massachusetts credit unions. Annual Report of the Massachusetts Commissioner of Banks for 1973, Section B at 46-79. The above data emphasizes the broad powers of Massachusetts credit unions to make real estate loans and and shows that many credit unions are, in practice, utilizing those powers in such a way that their loan activities are nearly identical to those of Federal associations.

While the Massachusetts Court did not reach the question whether any or all of the Associations would be en-

titled to relief ". . . if it were shown that one Federal association was in substantial competition with one or more credit unions," Mass. Adv. Sh. (1977) at 914, 363 N.E. 2d at 484, the statistics presented to the Court demonstrate such direct individual competition. For example, two of the Associations, Security Federal Savings and Loan Association of Brockton, and Montello Federal Savings and Loan Association of Brockton, have their offices in Brockton, Massachusetts. A. 10-11. Of the credit unions with more than 80% of their assets invested in mortgage loans, two are located in Brockton. Those two credit unions, the Brockton Brotherhood Credit Union and the Crescent Credit Union, had approximately 74% of their assets invested in real estate loans with over $25,000,000 in outstanding real estate loans and total assets of nearly $34,000,000. A. 146. Similar examples of Federal associations having their principal place of business in the same town or city as one or more credit unions with a major percentage of its assets invested in real estate loans may be found in the important markets of Boston, Brookline, Fitchburg and Lowell. A. 10-11, 146.

The above statistics are sufficient to establish competition at the individual level; it is not necessary to show that a particular credit union enticed a particular customer away from a particular Federal association. As stated by this Court in *First National Bank of Hartford, Wisconsin* v. *City of Hartford,* 273 U.S. 548 (1927):

> We do not conceive that in order to establish the fact of competition [within the meaning of the predecessor of 12 U.S.C. §548] it is necessary to show that national banks and competing investors solicit the same customers for the same loans or investments. It is enough as stated if both engage in seeking and

> securing in the same locality capital investments of the class now under consideration which are substantial in amount.

Id. at 559. In the companion case of *Minnesota* v. *First National Bank of St. Paul*, 273 U.S. 561 (1927), the Court concluded that actual competition existed between national banks and note brokers on the basis of general business statistics without a showing that the note brokers deprived the banks of any particular customers or any specific amount of business. *Id.* at 565-566. Indeed, the decisions of the Massachusetts Court, which held State-chartered cooperative banks and savings banks to be similar to Federal associations, appear to have been based upon less evidence of direct competition than the Associations have submitted in the present case. *See Commissioner of Corporations and Taxation* v. *Flaherty*, 306 Mass. 461, 461-462 (1940), *cert. denied*, 312 U.S. 680 (1941); *Springfield Institution for Savings* v. *Worcester Federal Savings and Loan Association*, 329 Mass. 184, 185-186, *cert. denied*, 344 U.S. 884 (1952).

The prior decisions of certain state courts to the effect that credit unions chartered by their respective states were not "similar" to Federal associations are not determinative of the issue in this case. Massachusetts credit unions are unlike many other state-chartered credit unions. Massachusetts credit unions are among the most active in the area of home mortgage loans. As noted by the National Credit Union Administration:

> In some States, loans outstanding secured by real estate comprised a *very substantial* proportion of total loans outstanding. For example, Massachusetts, New Hampshire, and Rhode Island each had more than 40% of their total loans outstanding secured by real estate.

National Credit Union Administration, 1973 Annual Report, "State-Chartered Credit Unions," 2-3 (emphasis added). At the end of 1973, credit unions in 32 states reported some real estate loan activity. Among those states with some such activity, real estate loans as a percentage of total loans outstanding ranged from less than 1% in Arizona to 54% in Rhode Island. *Id.* Thus, it is apparent that the determination of similarity must be made on a state by state basis.

In *First Federal Savings & Loan Association of New Haven* v. *Connelly*, 142 Conn. 483 (1955), *cert. denied*, 350 U.S. 927 (1956). The opinion of the Connecticut Supreme Court contained *no* discussion of the respective powers or practices of the two entities. The denial of jurisdiction on appeal, 350 U.S. 917 (1956), did not set forth the basis of denial.

A Minnesota decision contained an extensive discussion of the powers and practices of Minnesota credit unions, but those powers and practices were materially different from those of Massachusetts credit unions. *State* v. *Minnesota Federal Savings & Loan Association*, 218 Minn. 229 (1944). Membership in Minnesota credit unions was limited to persons with "a common bond of occupation or association, or a group within a well-defined rural district," *id.* at 236, while there is no limitation on membership in Massachusetts credit unions. The Minnesota credit unions had only $750,000 invested in real estate loans, *id.* at 232, contrasted with the over $329,000,000 invested in such loans by Massachusetts credit unions. The Minnesota credit unions were limited to real estate loans within 50 miles of their offices, unlike Massachusetts credit unions which may make real estate loans throughout the state. Moreover, the Court based its decision on the belief that

". . . the legislature 'has a wide discretion in classifying property for the purposes of taxation . . . .' ' ". . . the classification 'must be reasonable, not arbitrary, and must rest upon some ground of difference . . . .' " ' " . . . "The difference . . . need not be great . . . ."

Id. at 234 (citations omitted). It thus applied a standard more appropriate for determinations governed solely by the Equal Protection Clause of the U.S. Constitution.

While a New Hampshire case cannot be so readily distinguished on the basis of differences in statutory powers or actual practices, its result may be best understood in light of its use of the same totally inappropriate standard for determining similarity. In *Manchester Federal Savings and Loan Association* v. *State Tax Commission,* 105 N.H. 17, 20 (1963), the New Hampshire Supreme Court made the remarkable statement that:

> We do not blink at the fact that the state credit unions have similarities to the plaintiffs and the co-operative banks, that competition for the loan dollar exists. . . .

Despite this acknowledgment of similarity and competition, the Court upheld the New Hampshire tax. In so doing, it too assimilated the question of whether two entities are similar for purposes of 12 U.S.C. §1464(h) to the quite different question of whether a legislative classification has the minimal degree of "reasonableness" necessary to withstand a challenge under the Equal Protection Clause. The Court held:

> . . . we conclude that distinctions between credit unions on the one hand and federal savings and loan associations and cooperative banks on the other are substantial enough to warrant the exemption of the former and the inclusion of the latter without violating 12 U.S.C.A., §1464(h). *These distinctions* in size of operation, statutory restrictions and provisions, lending policy, ratio of real estate and unsecured loans to total assets, compensation of officers and in profit-making, *cannot be deemed to be negligible.* The Legislature has wide powers in the classification of subjects of taxation. The classification of credit unions as exempt from the franchise tax on banks *is a reasonable one which the Legislature had the power to enact without denial of due process or equal protection of the law under either the state or Federal Constitutions.*

105 N.H. at 20-21 (emphasis added and citations omitted).

By their failure to distinguish between a determination of similarity under 12 U.S.C. §1464(h) and one made solely under the Equal Protection Clause, these state courts have effectively nullified the Federal statute. Their opinions were based not on whether substantial similarities existed, but rather on whether any dissimilarities could be found, even if they were, in the words of the Minnesota Court, "not . . . great." 218 Minn. at 234. Even if such a standard were thought appropriate for Equal Protection purposes, it would not be sufficient in the face of the direct anti-discrimination mandate of a Federal statute. The many decisions under 12 U.S.C. §548 show that that statute provides greater protection than is provided under the Equal Protection Clause alone. This Court's statement in the *Laurens* case that discrimination is "unequivocally" prohibited indicates that 12 U.S.C. §1464(h) provides greater protection as well. To hold otherwise would be to make the statute superfluous.

In summary, the Associations urge that the proper method for determining similarity is a comparison of the

statutory purposes and powers of the entities and, in particular, that two entities are "similar" within the meaning of 12 U.S.C. §1464(h) if they have the power to compete with one another to a significant degree. Even if similarity is to be determined by a comparison of actual practices, as held by the Massachusetts Court, entities should be found similar if there is substantial competition. The statutory purposes of credit unions encompass the purpose of Federal associations and should be held to be similar. The statutory provisions governing the form of organization, acceptance of deposits and ability to make home mortgage loans for Massachusetts credit unions are substantially similar to those for Federal associations. Moreover, Massachusetts credit unions, in fact, make substantial real estate loans in direct competition with Federal associations. By subjecting Federal associations to taxation while granting Massachusetts credit unions a total exemption from taxation, Massachusetts General Laws, Chapter 63, Section 11, violates 12 U.S.C. §1464(h).

C. Massachusetts G.L. c. 63, §11 does Not Impose a Tax on an Authorized Subject of Taxation under 12 U.S.C. §1464(h) and Is Defective in Form.

It has long been established that the states have no inherent power to tax instrumentalities of the Federal government. *McCulloch* v. *Maryland,* 4 Wheat. 316 (1819); *Osborn* v. *Bank of the United States,* 9 Wheat. 738 (1824). The taxing power of the states is in this respect dependent entirely on the permissive legislation of Congress. *Owensboro National Bank* v. *Owensboro,* 173 U.S. 664, 668 (1899). Federal savings and loan associations are Federal instrumentalities like the national banks involved in the cited cases. *United States* v. *State Tax Commission,* 481 F.2d 963, 969 (1st Cir. 1973).

In authorizing the states to impose nondiscriminatory taxes on Federal savings and loan associations, Congress specifically enumerated the bases of such taxation, as follows:

> No State . . . shall impose any tax on such associations or their franchise, capital, reserves, surplus, loans, or income greater than that imposed by such authority on other similar local mutual or cooperative thrift and home financing institutions.

12 U.S.C. §1464(h). These are the only modes of taxation authorized.

The form of the statute suggests that the enumerated subjects of taxation are the exclusive bases of taxation permitted. The form of the statute also suggests that identical bases of taxation of Federal and state thrift institutions must be subjected to tax if a tax is imposed. For example, an attempt to tax the capital only of a Massachusetts cooperative bank while concurrently taxing the income only of a Federal association appears to be prohibited. If realistic and ready comparisons of the relative tax burdens of Federal and state associations are to be made, the conclusion is sound.

Considerable difficulty, however, is encountered in correctly identifying the character of the tax imposed by Mass. G.L. c. 63, §11. The complexity of the statute is the source of the difficulty, since the nominal subjects of taxation are not the true objects of the tax. For example, the so-called deposits element of the tax, dealt with by the Court of Appeals for the First Circuit, §§11(a)(2) and (b)(2), allows a deduction for the largest uses of deposits — real estate loans and banking facilities. The primary objects of the tax imposed by that portion of §11 are out-

of-state loans, personal loans and investments in intangibles.

Similarly, the so-called income measure of the tax, which is at issue here, variously labelled as an income tax and a franchise tax, was described by the Massachusetts Court as *a tax on the dividend paying capacity of the Associations.* The description is believed to be accurate. So defined, however, the tax must fail since "dividend paying capacity" is not an authorized subject of taxation under §1464(h).

Further, as a result of the decisions of the Massachusetts Supreme Judicial Court and the Court of Appeals for the First Circuit, the tax for state institutions is now measured in part by a tax on intangible investments and in part by an income-based element of tax, whereas Federal associations are taxed only on their "income," but at a greater rate. Thus, §11 as originally enacted and as now in force is defective in form because it utilizes different measures of the tax.

In interpreting a similar Congressional grant to the states of power to tax national banks, this Court described the statute in question, 12 U.S.C. §548, as "intended to prescribe the only ways in which the States can tax national banks." *First Agricultural Bank* v. *State Tax Commission,* 392 U.S. 339, 343 (1968). That statute has been described as "in pari materia" with 12 U.S.C. §1464(h), the provision involved here. *Michigan National Bank* v. *Michigan,* 365 U.S. 467, 481 (1961). Congress surely has been no less concerned to protect those institutions granted Federal charters as savings and loan associations than those chartered as national banks. Since, as is indicated below, the tax being challenged here is not one of those enumerated in the statute, it is not authorized. Even viewed in the light

of the descriptive labels applied by the lower courts, the tax ought still to fail for the reasons which follow.

1. *Franchise Tax.*

The Massachusetts Court has characterized this tax as a franchise tax. Mass. Adv. Sh. (1977) at 904-905, 363 N.E. 2d at 480. The characterization is not accurate and should be rejected. As this Court has stated:

> . . . neither state courts nor legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect. . . . [T]his Court must determine for itself by independent inquiry whether the tax here is what, in form and by the decision of the state court, it is declared to be . . . .

Macallen Co. v. *Massachusetts,* 279 U.S. 620, 625-626 (1929).

> . . . [T]he nature of a tax must be determined by its operation rather than by particular descriptive language which may have been applied to it.

Educational Films Corporation of America v. *Ward,* 282 U.S. 379, 387 (1931).

The taxes imposed upon corporations in Massachusetts historically have been in the nature of excises or duties upon the privilege of doing business in corporate form, that is, franchise taxes. *Provident Institution* v. *Massachusetts,* 6 Wall. 611, 616 (1867). Such a scheme of corporate taxation remains in use at the present time. In its design, §11 imposes a tax on two elements, deposits nominally and income nominally. The Massachusetts court relied on past decisions approving deposits and income as proper measures of the franchise, but such reliance was misplaced.

Deposits, however, are not the measure of the tax. Because of deductions provided for other uses, only those deposits committed to most extraterritorial real estate loans, personal loans and intangible investments are really subjected to tax. Less than 30% of deposits are so committed. A. 135-144. This highly particularized use of a small portion of deposits cannot be held to measure the value of a franchise.

The income-based portion of the tax is equally defective for two reasons. First, the deduction for additions to reserves is unrelated to income. See *infra* at 58-59. Second, the failure to provide for apportionment precludes the use of income as a franchise measure. That the privileges taxable by a state may be only those privileges which it has granted should require little discussion. Even absent the constitutional limitations on extraterritorial taxation discussed in Parts D and E of this brief, a state tax which takes the form of a franchise tax can only be applied to a corporation chartered by another sovereign to the extent that that corporation avails itself of the privilege of exercising its franchise in the taxing state. Where a franchise tax is measured by income, such income must be limited to that derived from carrying on business within the taxing state.

The draftsmen of Massachusetts tax statutes generally have recognized these inherent limitations on franchise taxation and have provided an allocation or apportionment mechanism in such statutes. For example, the income-based excise generally applicable to business corporations is limited by an apportionment formula so as to reach only income "derived from business carried on within the commonwealth." Mass. G.L. c. 63, §38. Utility companies doing business both within and without Massachusetts pay an

income-based excise on that portion of their net income "allocable to the commonwealth." Mass. G.L. c. 63, §52A(2). In the case of life insurance companies, the applicable excise is measured by premiums received during the year for policies "allocable to the commonwealth" according to specified rules. Mass. G.L. c. 63, §20. Foreign fire, marine and other non-life insurance companies are subjected to an excise measured by premiums and assessments during the year "for insurance of property or interests in this commonwealth, or which are subjects of insurance by contracts issued through companies or agents therein." Mass. G.L. c. 63, §23.

Provisions like those cited above are absent from the section being challenged here. That fact was ignored by the Massachusetts Supreme Judicial Court in the opinion below, though it recognized that the tax is one imposed on "the privilege of doing business *in the Commonwealth.*" Mass. Adv. Sh. (1977) at 905, 363 N.E. 2d at 480 (emphasis added). The Court noted that it had previously approved the measurement of a franchise tax by income, citing *State Tax Commission* v. *John H. Breck, Inc.*, 336 Mass. 277 (1957). In that case, however, the tax being challenged was the one imposed on business corporations, which, as noted above, provides an apportionment formula to prevent extraterritorial taxation. The Court in *Breck* specifically noted that the purpose of the apportionment formula

> . . . is, of course, to limit the net income measure of the excise to that reasonably attributable to activities within or closely associated with Massachusetts, so as fairly to reflect the annual benefit to the taxed corporation of its *corporate privileges* (including their exercise, if exercised) *under Massachusetts law.*

336 Mass. at 285 (emphasis added).

The record indicates that approximately 35% of the income of the Associations for the years described was derived from loans secured by real estate located outside Massachusetts. A. 134. At least part of that income resulted from the exercise by the Associations of corporate privileges under the laws of other states. Thus, the absence of a reasonable system of apportionment or allocation in Section 11 of Massachusetts General Laws, Chapter 63, prevents it from being a true franchise tax of the sort included among the subjects of taxation enumerated in 12 U.S.C. §1464(h).

2. *Income Tax.*

The Massachusetts Court stated further that, even if not a franchise tax, the tax in question constitutes an "income" tax within the meaning of the Federal authorizing statute. Mass. Adv. Sh. (1977) at 905, 363 N.E. 2d at 481. It is submitted that such is not the case. While there may be some differences in detail among the definitions of "income" for Federal income tax, state income tax, economic, and accounting purposes, all are based upon the concept of net income.

In construing the term "incomes," as used in the Sixteenth Amendment to the U. S. Constitution, this Court stated that, while the question had been discussed extensively by economists,

> . . . we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the Amendment . . . .

Eisner v. *Macomber,* 252 U.S. 189, 206-207 (1920). Applying that standard, the Court concluded:

> After examining dictionaries in common use . . . , we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 . . . — "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets . . . .

Id. at 207. Thus, "income" is measured by "gain" or "profit," that is, the actual economic benefit received.

Looking to dictionaries in common use, as did the Court in *Eisner* v. *Macomber,* yields the same result. Thus, Webster's Seventh New Collegiate Dictionary 424 (1970) defines "income" as "a gain or recurrent benefit usu[ally] measured in money that derives from capital or labor." Emphasizing again that only actual benefit is included, it defines "income tax" as "a tax on the *net* income of an individual or business concern" (emphasis added).

This common view is echoed in more technical sources. Thus,

> . . . as an economic concept income denotes a flow of wealth during a definite period, as opposed to capital as a fund of wealth at a distinct point of time. It may be defined as the money or money's worth which comes in during a definite period over and above the expenses of acquisition.

Seligman, *Income Tax,* 7 Encyclopedia of the Social Sciences 628-629 (1932), quoted in B. Bittker and L. Stone, Federal Income, Estate and Gift Taxation 39 (1972). In accounting terms,

> The income statement matches the inflow and outflow of assets resulting from enterprise operations for a specific time period. . . . The inflow of assets resulting from the sale of products or the rendering of services

represents revenue. Assets used to generate revenue constitute expenses. The income statement measures the difference between revenue and the expenses for a particular segment in the life of the business enterprise.

K. Solomon, Lawyer's Handbook of Accounting Theory and Practice 8 (1971).

The Massachusetts Supreme Judicial Court, in fact, has applied just such a definition of income in interpreting the Commonwealth's own statutes. In *Barnes* v. *State Tax Commission,* 363 Mass. 589, 591 (1973), it stated:

> "Income" was long ago defined as "net income" in the context of an act which required a payment to the State subject to measure by that income,

citing *Opinion of the Justices,* 46 Mass. (5 Met.) 596, 598 (1844). In *Bingham* v. *Commissioner of Corporations and Taxation,* 249 Mass. 79, 80 (1924), the Court stated that the word "income," as used in the individual income tax chapter,

> . . . may be said to include the true increase in amount of wealth which comes to a person during a stated period of time.

However, as will be indicated, the Court, in effect, failed in this case to follow the above principles when interpreting the Federal government's grant to the states of power to tax Federal savings and loan associations.

The tax imposed by Chapter 63, Section 11, of the Massachusetts General Laws, as construed by the Court below, is not one levied on "income," as that term is used in the cases and authorities just discussed. While Section 11 provides a deduction for "operating expenses" in determining the "net operating income" on which the tax

is imposed, the Supreme Judicial Court held that ". . . dividends and interest paid to members are not 'operating expenses.' " Mass. Adv. Sh. (1977) at 903, 363 N.E. 2d at 480. While that holding is conclusive as an interpretation of Massachusetts law, this Court can consider whether it precludes classification of the tax as one on "income," as that term was used by Congress in 12 U.S.C. §1464(h).

The above holding by the Massachusetts Court was based on its conclusion that a depositor in a Federal savings and loan association stands in relation to the association as an owner, not as a creditor, and that payments to him are therefore in the nature of dividends, however described, not interest. Mass. Adv. Sh. (1977) at 900-902, 363 N.E. 2d at 479. This view ignores the practical function of payments made by thrift institutions to their depositors and is in conflict with current Congressional views on the nature of Federal associations, as indicated by the tax treatment of such payments under the Internal Revenue Code.

Whether an interest in a corporation constitutes debt or equity has been often litigated in the context of the Federal income tax, and many tests have been developed. *See O. H. Kruse Grain & Milling* v. *Commissioner,* 279 F.2d 123, 125-126 (9th Cir. 1960). As this Court has stated:

> There is *no one* characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.

John Kelley Co. v. *Commissioner,* 326 U.S. 521, 530 (1945) (emphasis added).

While authorizing statutes and charters of mutual thrift institutions often utilize the terminology of ownership in describing depositors, using the word "dividend" in place

of "interest," for example, such depositors serve the same identical function as do depositors in non-mutual thrift institutions, *viz.* providing funds with which the institutions carry out their lending business. In order to characterize payments to such depositors, it is necessary to consider the relationship in practical terms.

The Massachusetts Court itself conceded that

> . . . account holders have ready access to their funds as a practical matter and it is likely that they think of their interests as substantially equivalent to cash. In this sense, a holder of an account is unlike the owner of a share in a corporation who cannot withdraw his ownership interest from the corporation at will. In particular circumstances State courts have concluded that the hybrid relationship between a depositor in a savings and loan association and the association creates a debtor-creditor relationship. See, e.g., *Mengele v. Christiana Fed. Sav. & Loan Ass'n,* 287 A.2d 395, 397 (Del. 1972) (Federal savings and loan association); *Family Sav. & Loan Ass'n Shareholders' Protective Comm. v. Stewart,* 241 Md. 89, 96 (1965) (State savings and loan association).

Mass. Adv. Sh. (1977) at 902, 363 N.E. 2d at 479, n.6. In addition, in contrast to the return on equity investments, which is determined by earnings, dividends or interest are paid by Federal associations as a percentage of deposits and at a rate determined primarily by the limitations established by the Federal Home Loan Bank Board. 12 U.S.C. §1425b(a). Deposits in a Federal association are also fixed in principal amount, experiencing neither capital appreciation nor erosion.

In considering debt-equity classification questions, the Federal courts have often focused on intent. Thus,

> It is often said that the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event.

Commissioner v. Meridian & Thirteenth Railroad Company, 132 F.2d 182, 186 (7th Cir. 1942). In the statement quoted in the previous paragraph, the Supreme Judicial Court recognized that the intent of depositors in a Federal association or other mutual thrift institution is identical to that of depositors in non-mutual banking entities, that is, to earn a fixed return for the use of their money while retaining a right to withdraw the amount deposited at will or according to well-defined rules.

The above conclusions are reinforced by consideration of the role of deposits in both mutual and non-mutual institutions. In each case, deposits are a source of the funds used to carry on the institution's lending business. In each case, fixed, periodic payments are made to depositors for the use of such funds. Whether called interest or dividends, such payments overwhelmingly constitute the single largest expenditure by such institutions. *See* SJC App. 90-91. A tax which fails to provide a deduction from gross receipts for the largest cost of doing business is a tax on something other than net income.

While not conclusive in this context, generally accepted accounting principles, as described in the audit guide, *Audits of Savings and Loan Associations,* published by the American Institute of Certified Public Accountants, support the deductibility of dividends or interest paid by savings and loan associations in determining net income. See definition of "dividend," SJC App. 92.

Finally, it should also be noted that a deduction is provided to mutual thrift institutions for Federal income tax

purposes for amounts paid or credited to depositors as dividends or interest. 26 U.S.C. §591. Congress should not be assumed to have intended that "income" be defined differently for purposes of Federal and state taxation. Further, the Federal tax treatment thereby provided was intended to ". . . place mutual savings banks [and other covered mutual thrift institutions] on a parity with their competitors." S. Rep. 781, 82d Cong., 1st Sess. 25-26 (1951). The competitors described above—non-mutual, stockholder-owned institutions—are denied deductions for the true dividends paid to their stockholders but are allowed deductions for distributions in the form of interest to depositors. 26 U.S.C. §163.

3. *Reserve Additions.*

The tax imposed by §11 is also prevented from being one described in 12 U.S.C. §1464(h) by the allowance of a deduction for ". . . minimum additions during the taxable year to its guaranty fund or surplus required by law or the appropriate federal and state supervisory authorities . . . ." The Supreme Judicial Court described the tax, without so labelling it, as a tax on the dividend paying capacity of thrift institutions by stating that the tax was:

> . . . measured by net income reduced by amounts of income which by law may not be made available, at least immediately, to members or depositors as interest or dividends.

Mass. Adv. Sh. (1977) at 906, 363 N.E. 2d at 481. "Dividend-paying capacity" is not one of the permitted bases of taxation enumerated in 12 U.S.C. §1464(h), however.

The allowance of a deduction for additions to reserves compounds the dissimilarity between what is sought to be taxed here and a tax on "income." The minimum required addition to reserves is an item irrelevant to "income" under any definition of that term. That is illustrated most graphically in the case of Massachusetts co-operative banks, whose required addition to guaranty fund is directly proportional to income. Mass. G.L. c. 170, §38. Thus, in that case, larger income results in a larger deduction and ultimately in a *smaller* tax.

Generally accepted accounting principles too support the view that such reserve additions are irrelevant to income. Thus, Accounting Research Bulletin (ARB) No. 43, Ch. 8, ¶12 provides:

> The following . . . should be excluded from the determination of net income under all circumstances:
>
> * * *
>
> (b)
>
> Amounts transferred to and from accounts properly designated as surplus appropriations, such as charges and credits with respect to general purpose contingency reserves.

SJC App. 106.

Finally, while "reserves" is listed among the bases of taxation enumerated in 12 U.S.C. §1464(h), the deduction for additions to reserves cannot be supported on that ground. The accumulated amount of reserves and the amount of required annual additions tend to be measures of opposites. While the former may perhaps be viewed as a measure of the strength or maturity of a financial institution, the latter, in contrast, are usually largest for new entities. To tax additions to reserves is to tax an absence or shortage of reserves themselves. Whatever Congress may have intended by authorizing taxation of reserves is unlikely to be achieved by taxing required additions thereto.

4. *Lack of Comparable Standards.*

Last, Section 11 is violative of 12 U.S.C. §1464(h) simply because it is defective in form. It provides for different and unequal measures of tax for the State and Federal institutions. The difference arises from the existence of different requirements for reserve additions for each type of thrift institution under §11. A second difference arises by reason of the earlier invalidation of the deposits portion of §11. For state institutions, the tax is measured by a deposits element and an income element. Federal associations, however, are taxed only on income, but at a greater rate.

It is of no consequence whether the statute is, as the Massachusetts Court described it, "wholly neutral." Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482. The presence or absence of discriminatory intent is not relevant under §1464(h). The use of different measures as the basis of tax inevitably produces differences in the taxes payable without the ability to make a valid comparison of relative tax burden. Section 1464(h) cannot be read to permit the use of separate measures which will inevitably produce unequal tax results. The concurrent use of one measure for Federal associations and a different measure for state-chartered institutions is not authorized. Such standards preclude direct comparison which appears to be at the heart of §1464(h), as interpreted by this Court in *Laurens,* in "unequivocally" barring discriminatory taxation.

Even if the state statute were wholly neutral in its use of separate standards for imposition of the tax, fortuitous comparative tax burdens on state and Federal institutions are not within the design of §1464(h). As stated in another case involving different measures of tax:

> If in a conceivable comparison between a domestic and a foreign corporation it should turn out that the foreign corporation paid no more or less than a domestic the result would be fortuitous; "the act has no tendency to produce equality; and it is of such a character that there is no reasonable presumption that substantial equality will result from its application."

Sneed v. *Shaffer Oil & Refining Co.,* 35 F.2d 21, 24 (8th Cir. 1929) (citation omitted). On this basis alone, the tax imposed by Section 11 of Massachusetts General Laws, Chapter 63, should be held to be beyond the scope of 12 U.S.C. §1464(h).

D. The Massachusetts Statute Violates the Commerce Clause by Its Failure to Provide for Apportionment of Income Derived from Other States.

In determining the "net operating income" which is the measure of the tax at issue here, the Massachusetts statute makes no provision for apportionment to in-state activities. Mass. G.L. c. 63, §11. During the period from 1966 to 1974, approximately 35% of the gross income of the Associations was derived from loans secured by real estate located outside Massachusetts. A. 134. By their very nature, such loans involve significant contacts with the states in which the mortgaged property is located. As will be indicated below, the Associations are thereby exposed to a real and substantial risk of multiple taxation.

The Commerce Clause of the United States Constitution grants to Congress the power ". . . [t]o regulate Commerce . . . among the several States . . . ." Article I, Section 8. This Court has described the purpose of that provision as ". . . to create an area of free trade among the several States." *McLeod* v. *J. E. Dilworth Co.,* 322 U.S.

327, 330 (1944). However, at least in modern times, it has also been clear that ". . . [e]ven interstate business must pay its way." *Postal Telegraph-Cable Co.* v. *Richmond,* 249 U.S. 252, 259 (1919); *Western Live Stock* v. *Bureau of Revenue,* 303 U.S. 250, 254 (1938). Balancing these two goals has been a "recurring problem" which this Court is here again asked to face. *See Michigan-Wisconsin Pipe Line Co.* v. *Calvert,* 347 U.S. 157, 166 (1954).

In striking such a balance, this Court has long held that a state is prohibited from imposing a tax on interstate commerce which could be imposed by other states touched by such commerce, thereby subjecting interstate commerce to cumulative burdens not imposed on purely local business. *Western Live Stock* v. *Bureau of Revenue,* 303 U.S. 250, 255-256 (1938). A state tax which is not apportioned so as to reach only activities within the taxing state has been held to create a risk of such multiple taxation and to be therefore forbidden. *J. D. Adams Manufacturing Co.* v. *Storen,* 304 U.S. 307, 311-312 (1938); *Gwin, White & Prince, Inc.* v. *Henneford,* 305 U.S. 434, 439 (1939).

It is the risk of multiple taxation which has been so condemned, not merely its actual occurrence. As was noted in *Gwin, White & Prince,*

> Unlawfulness of the burden depends upon its nature, measured in terms of its capacity to obstruct interstate commerce, and not on the contingency that some other state may first have subjected the commerce to a like burden.

305 U.S. at 440. That conclusion is not only fair and sensible as a matter of theory; it is also the only interpretation which, in practical terms, will enable Federal associations to fulfill their "key role in the housing market," promoting "the national housing policy 'to provide for

the economical financing of home ownership . . . by facilitating to the extent possible the interregional flow of mortgage funds . . . ,' " *United States* v. *State Tax Commission,* 481 F.2d 963, 968 (1st Cir. 1973) (quoting chairman of Federal Home Loan Bank Board), and yet preserve the power of the states to impose on such interstate commerce a fair charge for benefits conferred. Requiring proof of actual multiple taxation in every case would result in a "first-come-first-tax" system unfair both to the states and to those engaged in commerce. As between two states each having a substantial nexus with a particular transaction, such a system would deprive the second state of power to tax, even if its connection with the income- producing activity were greater than that of the first state. Each sate would have an incentive to throw its taxing net as far and as high as possible, as well as a strong disincentive to lifting, lowering, or modifying a tax because of the risk of "losing its place in line." Further, such a system would result in a mass of litigation and a burdensome administrative problem for state taxing authorities. A single transaction may touch many states and the overall business activities of a company still more. State A's tax might have priority with respect to that of state B while being itself invalid if the tax of state C is applicable. As this Court once stated:

> The immunities implicit in the Commerce Clause and the potential taxing power of a State can hardly be made to depend, in the world of practical affairs, on the shifting incidence of the varying tax laws of the various States at a particular moment.

Freeman v. *Hewitt,* 329 U.S. 249, 256 (1946).

It is not suggested that a bare theoretical possibility of multiple taxation should always be sufficient to invalidate

a state tax. In a case involving *ad valorem* property taxation in which established principles for determining taxing situs appeared to support full taxation by the domiciliary state, this Court required an actual showing that some part of the property had acquired a taxing situs elsewhere to deprive the domiciliary state of the power to tax. *Northwest Airlines, Inc.* v. *Minnesota,* 322 U.S. 292, 295 (1944). Where a challenged tax on gross receipts or net income provides for a method of apportionment, multiple taxation can result only from some imprecision in the formula, and this Court then has required an actual showing of multiple taxation, stating: "*In this type of case* the taxpayers must show that the formula places a burden upon interstate commerce in a constitutional sense." *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450, 463 (1959) (emphasis added).

An unapportioned tax, however, including one levied on or measured by net income, ". . . by its very nature makes interstate commerce bear more than its fair share." *Id.* at 462. In *General Motors Corp.* v. *Washington,* 377 U.S. 436 (1964), this Court refrained from passing on a claim of multiple taxation involving an unapportioned gross receipts tax, stating that it was adhering to the position taken in such cases as *Northwest Airlines* and *Northwestern States Portland Cement.* 377 U.S. at 449. That decision should not be interpreted as requiring proof of an actual multiple tax burden in every case. Both of the cases cited by the Court in *General Motors,* as described above, involved facts which gave rise to a presumption of the validity of the challenged tax and thus properly required proof of the contrary.

Further, the Court's refusal to pass on the multiple taxation claim in *General Motors* was not based on a lack of proof of multiple taxation; there was, in fact, apparently

proof that a St. Louis license tax did result in multiple taxation. *Id.* Rather, the Court described the defect in the taxpayer's case as a failure to demonstrate "what definite burden in a constitutional sense" had been placed on interstate commerce. *Id.* Thus, General Motors had failed to demonstrate that the challenged Washington tax would impede its interstate business. General Motors is part of an industry with primary manufacturing centers outside the state of Washington and thus is not in competition with local businesses able to benefit from whatever incremental tax burden might be placed on interstate business. Further, the state of Washington was the state of market in *General Motors.* The tax in question thus would be ultimately passed on to consumers resident in Washington and represented in the legislature which enacted or continued the tax rather than to out-of-state purchasers with no political remedy. In *Gwin, White & Prince, Inc.* v. *Henneford,* 305 U.S. 434 (1939), cited earlier for its holding that the mere risk of burdensome multiple taxation violated the Commerce Clause, *supra* at 62, this Court invalidated a tax similar to that involved in *General Motors* where the tax was applied to *outgoing* sales. The Court in *General Motors* did not overrule the *Gwin* case and, in fact, cited it in its opinion. 377 U.S. at 448.

Again, it is not suggested here that a mere theoretical possibility of multiple taxation must bar a state tax, even where unapportioned taxes are involved, though such taxes have been held to be inherently burdensome to interstate commerce. Even in such cases, Mr. Justice Rutledge noted, there might be instances in which there existed no real likelihood of multiple taxation. In *Freeman* v. *Hewitt,* he suggested that the proper test should be

> . . . whether those forbidden consequences would be produced, either through the actual incidence of mul-

tiple taxes laid by different states or by the threat of them, with resulting uncertainties producing the same impeding consequences.

329 U.S. at 274 (Rutledge, J., concurring). A state tax would be invalidated only if the risk of multiple taxation were "real and substantial." *Id.* n.33. While such a test would result in a greater burden for litigants, it would not create the earlier described inequities, the flood of litigation, or the administrative burdens as would result from a requirement of proof of actual multiple taxation.

The risk of multiple taxation to which the Associations are exposed is "real and substantial." The Associations derive significant amounts of income from loans secured by real estate located outside Massachusetts. The business of Federal associations is such that their loans involve significant contacts with the state in which the mortgaged property is located. The security can be protected only by use of that state's facilities for recording of mortgages. Further, an extensive program of mortgage investment inevitably results in periodic foreclosures, usually requiring resort to the courts or administrative procedures of the state in which the property is located. Factual proof of a logical certainty ought not to be required. Such activities constitute a direct nexus between the Associations and the recording state which would justify that state's imposition of a tax.

In *Brady* v. *John Hancock Mutual Life Insurance Company*, —— Miss. ——, 342 So. 2d 295 (1977), the Supreme Court of Mississippi held that that state had jurisdiction to tax interest income of a non-resident corporation based upon the fact that the loans in question were secured by real estate within the taxing state and the security interests were recorded there, even in cases in which the non-resident had purchased mortgage loans from independent

contractors and had held and serviced them outside the state. This Court recently dismissed the appeal in the cited case. —— U.S. ——, 98 S. Ct. 32 (1977).

The possibility of such multiple taxation presents a real and substantial burden for interstate commerce in the instant case. Mortgage loans are not short-term transactions but generally extend for twenty-five to thirty years. Thus, each loan decision constitutes a long-term commitment by the lending institution which cannot be terminated in the event that a currently acceptable level of taxation is substantially increased. In recent years, more and more states, faced with spiraling governmental costs, have been forced to increase existing taxes and to seek new sources of tax revenues. There is no reason to think that this process will not continue or even accelerate. In that context, a Massachusetts tax lacking any apportionment provision creates for Federal associations domiciled in Massachusetts a strong disincentive against extraterritorial lending, since any tax imposed by the second state in the decades that follow will constitute a burden which could have been avoided by restricting business to Massachusetts. In effect, the possibility of such taxation results in ". . . such actual uncertainty that this uncertainty itself . . . constitute[s], in practical effect, a substantial clog" to interstate commerce. *Freeman* v. *Hewitt*, 329 U.S. at 274, n.33. (Rutledge, J., concurring).

That the risk of multiple taxation in this context poses a real and substantial threat to interstate commerce has been recognized by Congress, which in 1973 passed the State Taxation of Depositories Act to provide temporary relief from the threat of such taxation ". . . until such time as uniform and equitable methods are developed for determining jurisdiction to tax and for dividing the tax base among States." P.L. 93-100, §7, 87 Stat. 347 (1973). The

Act prohibited any state from imposing "... any tax measured by income or receipts or any other 'doing business' tax on any insured depository not having its principal office within such State." *Id.* A Federal savings and loan association is included in the definition of "insured depository." *Id.* The Act originally applied to taxable years beginning before January 1, 1976, but was extended to cover those years beginning before September 12, 1976. P.L. 94-222, §1, 90 Stat. 197 (1976). Thus, the protection provided by the Act has now expired, leaving the Associations again subject to the risk of multiple taxation.

Congressional concern over this problem has continued following the expiration of the Depositories Act. Senator Thomas McIntyre, Chairman of the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing, and Urban Affairs has introduced a bill which would establish a uniform jurisdictional standard and provide a detailed apportionment formula to govern situations in which more than one state has jurisdiction to tax. S. 1900, 95th Cong., 1st Sess. (1977). In hearings on this bill, there was testimony that approximately thirty states have legislation or regulations that could be used to tax out-of-state depository institutions on interstate transactions like those involved here, that actual taxation had been delayed only in anticipation of possible Congressional resolution of the issue, and that, absent such a resolution, such taxation would soon result. Hearings on S. 1900 (Senate Report not yet published), November 22, 1977, Statement of R. James Alerding on behalf of American Bankers Association. In the face of diverse rules and possible over-apportionment through non-uniform combination, it was predicted that many depository institutions would curtail loans across state lines or refrain from acquiring out-of-state mortgages. *Id.*, Statement of C. James Judson on behalf of American Bankers Association.

That Congress has expressed such concern regarding state taxation of Federally-chartered financial institutions indicates the magnitude of this continuing threat to the free flow of funds among the states. While Congress could remove the threat by legislation, it has not done so yet. Further, while the State Taxation of Depositories Act provided protection during certain of the years since passage of Massachusetts General Laws, Chapter 63, Section 11, others were not reached by that statute. In summary, the Massachusetts tax has placed on the Associations a real and continuing burden to the extent they wish to engage in interstate commerce, as authorized by their Federal charters.

The Massachusetts Court conceded that §11 fails to make any attempt to distinguish between income received from activities within the State and income from activities outside the State. Mass. Adv. Sh. (1977) at 907, 363 N.E. 2d 474, 481. The Court further acknowledged that "... *collectively* the associations invest a substantial portion of their funds (about 29% in 1974) in mortgage loans secured by real estate located in other States," but upheld the statute on the ground that "the record is devoid of any information with respect to the contacts of any *individual* Federal savings and loan association in any other jurisdiction." *Id.* at 907-908, 363 N.E. 2d 474, 482 (emphasis added). This distinction between the collective and individual activities of the Associations is without substance here. A significant number of individual associations must necessarily be in the business of making out-of-state real estate loans if nearly a third of the Associations' collective assets are invested in such loans.

As noted earlier, it as a real and substantial risk of multiple taxation which should be held to violate the Commerce Clause. The activities of individual institutions are

relevant only as one indication of the magnitude of that risk. Federal associations border on all five states adjoining Massachusetts, and all Federal associations have the power to make direct mortgage loans outside Massachusetts. 12 U.S.C. §1464(c). Over $300,000,000 of revenues were received by the Associations from out-of-state sources between 1966 and 1974. A. 134. Thus, it is clear that there is potential risk for all of the Associations and that a clear and present risk already exists for many as to a significant portion of their investments. The identity of the individual institutions in the latter category is hardly relevant, especially in a declaratory action such as this.

E. The Massachusetts Statute Violates the Due Process Clause by Its Failure to Provide for Apportionment of Income Derived from Other States and by Its Use of Separate and Unequal Standards for Measuring Deductions.

During the period from 1966 to 1974, approximately 35% of the gross income of the Associations was derived from loans secured by non-Massachusetts real estate. A. 134. The failure of Chapter 63, Section 11 of the Masachusetts General Laws to provide a mechanism for apportioning income from such transactions among the states violates the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

The Fourteenth Amendment provides that "No State shall . . . deprive any person of life, liberty, or property, without due process of law . . . ." Corporations are "persons" protected by this provision. *Pembina Consolidated Silver Mining and Milling Co.* v. *Pennsylvania*, 125 U.S. 181, 189 (1888). It follows that a state may not compel a corporation to pay taxes without due process.

The most commonly cited formulation of the Due Process standard as applied to state taxation of multi-state business is this Court's statement that a state may not utilize a method of taxation which ". . . operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123, 134 (1931). As this Court later explained:

> . . . a state which controls the property and activities within its boundaries of a foreign corporation admitted to do business there may tax them. But the due process clause denies to the state power to tax or regulate the corporation's property and activities elsewhere.

Connecticut General Life Insurance Co. v. *Johnson*, 303 U.S. 77, 80-81 (1938).

The Due Process Clause does not prohibit all taxation of income arising from out-of-state business transactions. It has long been established that such income may be included in the measure of a tax so long as it is properly apportioned among the states related to the transactions which gave rise to the income. In response to an argument that formula apportionment violated the Fourteenth Amendment by taxing, directly or indirectly, income arising from out-of-state business activities, this Court stated:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States . . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of appor-

> tionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State . . . . There is . . . nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result.

Underwood Typewriter Company v. *Chamberlain,* 254 U.S. 113, 120-121 (1920).

Like the transactions involved in the *Underwood Typewriter* case, the Associations' activities in making mortgage loans secured by non-Massachusetts real estate relate not just to the taxing state but to another state as well, in this case the state in which the mortgaged property is located. For Massachusetts to impose on the Associations a tax measured directly or indirectly by their income without apportioning it in any way is "inherently arbitrary," in the words of the *Underwood Typewriter* opinion. The full burden of an unapportioned tax such as this falls on all income of the taxpayer, whether or not attributable to transactions within the taxing state. Thus, proof of any out-of-state income satisfies the taxpayers' burden, described in *Butler Brothers* v. *McColgan,* 315 U.S. 501, 507 (1942), of showing that extraterritorial values are being taxed.

Section 11 also violates the Due Process Clause in a second way. While, on its face, the statute appears to treat State-chartered banks and Federal associations equally, in operation it makes a distinction which is arbitrary, unreasonable and much to the detriment of the Federal associations. The reserve deductions allowed State-chartered banks are determined by the legislature and have remained fixed since the statute was enacted in 1966. The reserve deduction allowed Federal associations is determined by

Congress and the Federal Savings and Loan Insurance Corporation and has been repeatedly adjusted to reflect goals wholly unrelated to tax considerations. See discussion *supra* at 24-25.

The statute thus distinguishes between the Federal associations and State-chartered cooperative and savings banks despite the fact that they are "similar" for purposes of 12 U.S.C. §1464(h). *United States* v. *State Tax Commission,* 481 F.2d 963, 968 (1st Cir. 1973). The use of totally different methods for computing the same deduction for members of the same class under the same tax statute violates the due process requirement of *International Shoe Co.* v. *Washington,* 326 U.S. 310, 319 (1945), that economic regulation not be "unreasonable, arbitrary or capricious."

F. The Use of Separate and Unequal Standards for Measuring Deductions Violates the Equal Protection Clause.

As indicated in the discussion of the Due Process Clause in Part E of this brief, Massachusetts General Laws, Chapter 63, Section 11, provides different methods of computing the deduction for reserve additions in the case of Federal associations, on the one hand, and Massachusetts-chartered savings and cooperative banks on the other. The result has been consistently lower deductions for the Federal institutions. Mass. Adv. Sh. (1977) at 909, 363 N.E. 2d at 482; A. 16-132. Federal associations have been held to be similar to such State-chartered banks for purposes of 12 U.S.C. §1464(h). *United States* v. *State Tax Commission,* 481 F.2d 963, 968 (1st Cir. 1973). Application of different measures for the deduction in question violates the requirement of the Equal Protection Clause of the Fourteenth Amendment that a law must apply equally to

all those within appropriate classifications. *See, e.g., McLaughlin* v. *Florida,* 379 U.S. 184, 190 (1964).

Conclusion.

For the foregoing reasons, the tax imposed on "net operating income" by Massachusetts General Laws, Chapter 63, Section 11(a)(1) and (b)(1), should be held to be invalid as applied to Federal savings and loan associations, and the decision of the Supreme Judicial Court of Massachusetts should be reversed.

Respectfully submitted,

CHESTER M. HOWE,
MAXWELL D. SOLET,
OLIVER W. STALTER,
GASTON SNOW & ELY BARTLETT,
One Federal Street,
Boston, Massachusetts 02110.
(617) 426-4600
Attorneys for the Appellants.